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Toronto Office

The Province of Alberta

IN THE MATTER OF "THE NATURAL GAS UTILITIES ACT"

—and—

IN THE MATTER OF an Enquiry into Scheme to be adopted for Gathering, Processing and Transmission of Natural Gas in Turner Valley

G. M. BLACKSTOCK, Esq., K.C., *Chairman*

Dr. E. H. BOOMER, F.C.I.C., *Commissioner*

Session:

CALGARY, Alberta October 10th, 1945

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I N D E X

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VOLUME 47

9.30 A.M. Session,
October 10th, 1945.

MR. BLANCHARD: Mr. Chairman, at adjournment yesterday I directed a question to the witness with reference to the propriety of adopting one or other of the several alternatives of the rate bases discussed by him in his evidence yesterday, and I think Mr. Chambers rose to object to any opinion evidence of that character. Now if the objection is persisted in I do not propose to lead that evidence, although I think it is both relevant and admissible. The reason that it is offered is for the same reason that prompts the Board to call its accountants to present to the Board such evidence as the accountant gathers and then submit him to cross-examination by all parties, and if my learned friend objects to his going to the extent of giving his views as to the propriety of adopting one or other of the rate bases I am not going to insist upon it.

THE CHAIRMAN: If you are going to lead the evidence, Mr. Blanchard, we are going to hear it. If it is objected that Mr. Hamilton is not an expert in the matter of constructing a rate base, I would like to know where we can find such a person as an expert.

Mr. Hamilton is a Chartered Accountant of wide experience and a knowledge of financial matters and I think his opinion is valuable. We may not adopt it, but it might help in the solution of the ultimate problem and for that reason we are prepared to hear it if you wish to lead it.

MR. BLANCHARD: Sir in view of your remarks then I will lead the evidence subject to what my learned friend may say.

MR. CHAMBERS: I persist in registering my objection. In the first place I submit that it is the duty of the Board on facts adduced in evidence before it and on the opinion of expert witnesses as to matters requiring specific and special training and experience such as Mr. Hill in the matter of reproduction costs, Mr. Hamilton if you like on the matter of accounting and financial statements, but I do submit that the Board if there is no such animal as an expert on rate base, then it might very well be that the Board has to be the expert or it has to come to the opinion on the facts that are before them and in any occasion I do submit that my learned friend has not so far at least adduced any evidence here as to the qualification of this witness that is now offered as an expert on the rate base matters and if the evidence is to be proceeded with I would like the opportunity now before it is given to cross-examine the witness as to his qualifications.

THE CHAIRMAN: And how did Mr. Mercer qualify to give evidence as to market sharing position and allocations as to costs - just an accountant, not even a Chartered Accountant.

MR. CHAMBERS: Mr. Mercer was called to give evidence and his evidence in chief was directed as to what Royalite as one of the parties before this hearing was prepared to offer or agreed to do as a matter of agreement. Now he was asked all kinds of questions on cross-examination which I submit strictly he should not have been asked, but as I intimated earlier in the hearing I was loathe to object to every question asked and I think I have already registered my general objection to opinion evidence being taken from any witnesses that are not experts and qualified as experts on matters with respect to which the questions are asked.

THE CHAIRMAN: Well if you wish to cross-examine Mr. Hamilton you can, but I am going to tell you in advance that having finished the cross-oxamination, if Mr. Blanchard wishes to lead the evidence we will hear it.

MR. CHAMBERS: Then I take it from the last remark, no matter what questions I ask along that line the evidence will be taken.

THE CHAIRMAN: Yes, but you ask your questions just the same.

MR. CHAMBERS: Then I do not think it is worth while now.

THE CHAIRMAN: I am giving you the right to ask your questions.

MR. CHAMBERS: Well I will pursue them so it may be on the record in any case.

CROSS-EXAMINED BY MR. CHAMBERS:

Q Now Mr. Hamilton as I understand it you are a member of the Institute of Chartered Accountants for the Province of Alberta ?

A Yes sir and of British Columbia.

Q Of British Columbia. Where did you take your training which led to your qualifications as a Chartered Accountant ?

A I am a graduate of the University of Alberta, School of Commerce, the degree of Bachelor of Commerce. I trained in Edmonton with my present partner Mr. F. G. Winspear, and have practised in the firm which was subsequently formed between himself and myself since 1933 on.

Q And you have carried on the practice of your profession at the city of Edmonton ?

A Centering in the City of Edmonton.

Q And your practice has been confined to the Province of Alberta ?

M-1-3
H. A. Hamilton,
Dir. Exam. by Mr.
Cross-Exam. by Mr. Chambers.

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Q And you have carried on the practice of your profession at the City of Edmonton ?

A Centering in the City of Edmonton.

Q And your practice has been confined to the Province of Alberta

A And British Columbia.

Q And British Columbia. How long did you practice your profession in the Province of British Columbia ?

A Upwards of twelve years.

Q Then as I understand it you have been in active practice since about 1933 ?

A Correct.

Q Now would you relate to us in a more or less general way your professional experience as a Chartered Accountant from 1933 down to the time you were first engaged in connection with this matter ?

A The practice of Chartered Accountancy is a very general practice sir. As a member of that firm I have had the responsibility of conducting audits of many types and characters but with particular reference to public utility matters I feel perhaps it is proper to say at this point I have never engaged on a hearing of this sort until last year when I was engaged to appear and attend on behalf of the Attorney General in these present proceedings.

Q By the way are you representing the Attorney General or have you been retained by the Board in this particular matter ?

A My firm was engaged as auditors by the Board by Order-in-Council and directed to assist the representative of the Attorney General's Department.

Q Now I think you just told us that prior to your being engaged in this matter your firm had a certain amount of public utility practice ?

A I said I had not appeared in a hearing of this sort.

Q Have you acted as auditors for public utility companies prior to the hearing ?

A You speak now sir of public utility under regulation ?

Q Yes.

A No sir.

Q Did you act in any matter or proceedings against public utility companies prior to these proceedings ?

A My firm has, yes.

Q But you yourself, were you yourself actively in charge of that matter ?

A Not to any material degree.

Q Now Mr. Hamilton what if any examination and inspection have you made of the property in respect of which you are now going to recommend a rate base to this Board ?

A A mere general inspection in company of an engineer, Mr. Rogers by name, who is attached to this Board, a casual survey of the property so that we might have some understanding of the nature and extent of those properties.

Q But of course as I understand it you made no specific examination in the sense that Mr. Hill did ?

A As to the physical values of the property, none whatsoever.

Q The physical properties and their actual condition and design and so on ?

A None whatsoever.

Q Now would you please outline for us your knowledge and experience of the gas business, the natural gas business, the nature of the business that is now under review other than what you acquired in this particular proceeding ?

A None whatsoever except living with it the last twelve months.

Q And until you were engaged in this matter I take it you had no specific knowledge as to pipe or gathering lines or compressors or scrubbing plants or anything of that nature ?

A Your understanding is correct, sir.

Q That is all.

Now I think probably in fairness to the Board at least that I should refer the Board to one or two cases before the Tribunals and Courts in the United States and I would refer to the American authorities because this matter naturally has come up there to a greater extent than it has in this country.

The first case to which I refer is the Westinghouse Electric and Manufacturing Company vs. Denver Tramway which is reported in 1925 B Public Utility Reports Page 156, and it is a decision of the United States District Court where the Court in effect holds this. I have not the reports here, but I have taken the extracts if the Board pleases from the Public Utility Digest. Now the digest of that case that I have obtained from the Public Utility Digest reads as follows:

> " Error in matter of law exists in permitting a witness to testify as an expert when it is not shown that he possesses the necessary qualifications that on account of special knowledge, skill or experience possessed and enjoyed by him over others, his opinion on the subject of inquiry will aid the Court or Jury to a correct conclusion. Evidence on normal or historical valuation of a street railway property introduced by a non-expert witness is valueless when he not only testifies as to book costs but so modifies and enlarges and restricts such non-expert testimony by his personal opinion as to render the non-expert testimony and the opinion evidence inseparable."

I would also like to refer the Board to the case of Rankin vs The Northern P. R. Company 1924 D, Public Utility Reports, Page 545, a decision of the Montana Board.

"Observations as to reasonableness of rates by those who have not had previous experience or study can count for nothing in the solution of a problem which sometimes baffles even those best qualified to pass upon it".

And one other, the Atlas Underwear vs. Ritchie, 1931 E, Public Utility Reports at Page 403. That was a Virginia case and I think if my recollection is correct that it was before the Virginia Board, not the Court.

"Statements by an expert witness not in line with his qualifications as an expert were not admitted in evidence".

In the light of the cross-examination of the witness that I have just made and in the light of those authorities I am objecting to this evidence being taken.

MR. BLANCHARD: The general criterion is that the witness cannot give opinion evidence unless he qualifies as an expert. That is the strict legal rule here. The Board is not bound by technical rules of evidence at all. The cases cited by my learned friend do not state what the profession or business of the witnesses offered who gave evidence were. It may be upon a Geologist giving opinion evidence upon accountancy or something quite foreign to him. Now in giving evidence of a rate base it seems to me a knowledge gained over a number of years on financial matters, close association with companies who are engaged in business in that way and a thorough knowledge of accountancy qualify a witness to give some opinion as to the appropriateness of one rate base as against another and to comment on the weakness inherent in the adoption of the one

as against another.

Now we have had evidence by accountants who have placed before this Board submissions which are, if of any value, opinions as to what should be done and we will perhaps come to this. The city may desire to call Mr. Morrison. I do not know whether they will or not to say such and such a rate base should be accepted and that in the light of all the evidence is the proper rate base. Now he would be excluded completely if my learned friend is correct in this because he is offering again opinion evidence. I think Mr. Morrison can qualify as having taken part in public utility hearings. But the opinion evidence that is now being offered is that of an accountant who has been intimately connected with these proceedings from the start. Who has had an opportunity of scrutinizing with great care all submissions made. Who has brought his experience as an accountant to bear upon the accounting submissions and who has actually examined the books upon which the submissions have been based and presented.

Now it is a matter which I do not propose to press at all. As I say, Mr. Chairman, it is almost impossible to conceive how any witness can give opinion evidence at all on a rate base because there are not rate base experts available. It involves accountancy and it was being offered - this evidence was being offered - so that the Board might hear an accountant weigh the various considerations that have been presented in various submissions and be subject to cross-examination as to adoption of the one or the other.

(Go to Page 3640)

MR. HARVIE: I wish to join Mr. Chambers in objecting to this witness giving this suggested evidence. I do not think he has qualified himself as an expert and particularly with regard to his views on my clients' particular problem. You will remember in the earlier part of the proceedings we were asked to supply some book values for the purpose of giving a historical record of the cost. We objected to doing that but we were in effect ordered by the Board to do it. We advised the Board that while we did it we did not think the figures on our books were fair or could be used for the purposes we anticipated they would be used if supplied. It is now quite apparent that it is proposed to use them for that purpose and I wish to join in raising that objection.

Q THE CHAIRMAN: Mr. Hamilton, as I understand it you are not setting yourself up as an expert in the matter of the construction of a rate base?

A Sir . . . . .

Q I do not know what an expert is. They are called experts. Are you setting yourself up as that mythical character that we hear spoken of so often, an expert?

A I do not know whether I am an expert or not in any matter. I certainly would not presume to invade a field that is not my own but on the other hand I do not wish to avoid a responsibility that might be mine.

Q You have made an examination of the books of Royalite?

A Yes.

Q And the books of the British American as well?

A No sir.

Q But you were furnished with information by both companies on information taken from their books?

A Yes.

Q Have you made any study of literature relating to rate bases in relation to the problem that we are dealing with?

A Yes sir, a great deal.

Q In the last year only, or prior?

A Pretty well confined to this last year, that is any special study. I have had general knowledge of the problems of rate base determination for many years.

Q And this evidence which Mr. Blanchard proposes to lead is being given by you in your capacity as an accountant and a business man rather than as a so-called expert?

A Quite, sir.

Q As an accountant and a business man?

A Yes sir.

THE CHAIRMAN: Now Mr. Blanchard if you wish to lead the evidence, the Board will hear it.

MR. BLANCHARD: Very good, sir.

Q Now then Mr. Hamilton you have prepared, I believe, a submission containing your comments on the several rate bases that have . . . . . alternative rate bases in Exhibit 124 and you have prepared comments in relation to those alternative bases?

A Yes, sir.

Q Has that been put in the form of a typed statement?

A It was originally intended, sir, as merely notes for my own purposes. Arising out of comments made at the close of yesterday's session, I believe that these notes were mimeographed. I am not certain whether they were or not but I believe they were for the information of counsel.

MR. BLANCHARD: I think the simplest thing to do would

be to put in this submission and to mark it as an Exhibit and then let the witness read it.

SUBMISSION BY MR. HAMILTON
AS TO RECOMMENDED RATE BASES
IS NOW MARKED EXHIBIT 125.

MR. BLANCHARD: Mr. Harvie kindly offered to make copies for me yesterday but I found this morning that he had only made three or four, so that I am not in a position this morning to distribute copies to everyone. However if it is read, perhaps copies can be furnished a little later.

A I wonder whether you would care to have this introduced at this stage or whether you would rather we deal with the accounting aspects of the British American rate base first.

MR. BLANCHARD: Well that depends, Mr. Chairman, on whether we are going to deal with the Madison rate base in its entirety and then to proceed to cross-examination on that rate base, or else deal with the rate bases of both of these companies and proceed to cross-examination.

THE CHAIRMAN: We would prefer to have the Madison rate base direct examination and cross-examination completed before we go to British American.

MR. BLANCHARD: That was my feeling and that being the case it seems to me . . . . .

MR. HARVIE: I might say we were anticipating that would be the procedure and Mr. Donellan, thinking that would be the case, is not present. So I would prefer if it proceeded that way.

Q MR. BLANCHARD: That being the case, sir, I think the witness can read at the present moment for the information of the Board and counsel that portion that relates to Madison. The Exhibit may go in and the other then may be

read at another time.

THE WITNESS: That will comprise, sir, pages 1 to 6 inclusive, if the mimeographed copy conforms to the typed copy.

MR. STEER: Has that been given a number?

THE CHAIRMAN: Exhibit 125.

A Again I may say these are merely informal notes which I took for my purposes and consequently are not in formal form. It reads as follows: If the Board pleases I might now make a few comments arising out of the evidence which has been placed before this hearing as it may affect the propriety of the various alternative rate bases here suggested.

First of all, with regard to Madison. It should be borne in mind that in my view at least, rate base and rate of return cannot be wholly dissociated - - a low rate base coupled with a high rate of return may compensate adequately, and conversely a high rate base coupled with a low rate of return may likewise compensate adequately. The danger of course lies in combining a disproportionately high rate base with a disproportionately high rate of return, or conversely from the viewpoint of fairness to the utility a disproportionately low base with a disproportionately low rate of return.

With regard to the rate base itself, it appears to me the problem should be, for clarity, resolved into its two components:

1) The selection of the gross valuation.
2) The reduction of the gross valuation in respect to depreciation.

Dealing with the gross valuation, the only

rate base suggested on behalf of the company was the Reproduction Cost New as of the date of coming under regulation. There are of course other gross valuation formulas that might be suggested -- for example:

Reproduction Cost New as of a date other than the one suggested - - or as of a selected period;

or again you might use

Historical Cost - and by that, I mean the cost as it appeared in the books.

or

Adjusted Historical Cost - by which I mean the cost as it actually was, whether it so appears in the books or not.

Then again you might select a

Combination of 2 or more of these bases

or finally you might arrive at an

Arbitrary valuation taking all these into account or taking even extraneous factors into account.

Mr. Hill in his evidence I believe stated that reproduction cost was one, but only one approach, and that it was quite proper to suggest the Board might have regard to other factors or other approaches. I take it that the principal justification for Reproduction Cost New at date of taking over lies in the fact that this valuation reflects what the cost of the plant would be if it were erected at that time. This however does not appear to me a realistic approach. Actually the plant was not so constructed and the evidence would indicate that if a plant were to have been constructed in 1943 it would not have been the same plant in physical terms. For example I took Mr. Hill's evidence together with Mr. Stevens-Guille's evidence to indicate that

that there would have been no Seaboard -- but there is a Seaboard. Furthermore the evidence suggests that the lines, gathering lines, would not be precisely where and as they are, but they are precisely where and as they are.

Mr. Hill's evidence also clearly indicated that prices current at the time of his appraisal were substantially higher than the average obtained during the whole period of construction. This of course would result in a substantial capital gain accruing to Royalite -- the sort of gain which in my view one might reasonably assume would be split somehow between a willing buyer and a willing seller. One wonders what the situation would be if the shoe were on the other foot -- that is to say if the sale were consummated at a period when reproduction cost were below historical (or actual cost).

The same objections apply with equal force to a Reproduction valuation based on a date other than 1943 -- either another date, or over another period. The facts are that the plant probably never would have been reproduced in the form in which we find it. There is of course another complication, and that is what date or period to select.

Turning now to historical cost we find two main issues arise:

1) The fact that historical cost does not embrace all the costs that could have been capitalized.
2) The fact that no part of the capital gain accruing from advanced price levels accrues to the company.

As to the first -- viz. "That historical cost does not embrace all the costs that could have been

"capitalized.", it seems to me that the company is entitled to the full costs of construction regardless of how its books were kept. It is significant that the company was not then under regulation and was not answerable to customers, consumers or any rate regulating body, and the material fact in my view is what was the cost rather than what it shows to be on the company's books.

On the evidence to which I have listened the 9% suggested by Mr. Hill, borne out by my own experience as an accountant, would not appear unreasonable. We have therefore included, I might mention this parenthetically, in WH 6 an amount of $226,671 representing an approximation of those elements of cost which might properly have been capitalized and which were not capitalized. The principal item there was the 9% overhead allowance which we adopted from Mr. Hill's recommendation and on the evidence to which I have listened the 9% suggested by Mr. Hill, borne out by my own experience in accounting, would not appear unreasonable.

As to the second question - - viz. "That no part of the capital gain accrues to the company". This is of course an objection from the company's point of view, and it rests on the thesis that the company is denied a profit that it could otherwise have gained. I question whether this is so. There is nothing to suggest that Royalite ever would have sold this system now or at any time in the future. In point of fact it was under contract to deliver gas under a firm contract and its investment in plant would ultimately have been realized out of the sale price of gas over the next twenty-five years or so, and the plant is there and will stay there. One comes to the conclusion that any capital

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gain arising from cost appreciation is merely "paper profit". The price of gas to Royalite's then customer was last fixed in 1928 and has remained constant through several serious changes in general price levels.

I believe, however, that some recognition should be given to replacement values in cases of items separable from the main plant and which have a more transitory existence and whose market value fluctuates. I therefore would consider it appropriate to adopt replacement for such items as automotive equipment and office furniture and I should say field furniture and equipment.

The second phase of rate base determination lies in the selection and application of a depreciation formula.

The basis of observed depreciation suggested by Mr. Hill obviously gives recognition only to the physical aspect of depreciation, viz. "wear and tear and the action of the elements". It will be recalled that Mr. Hill stated - and I refer now to his evidence on page 1723 - that functional depreciation might well be taken into account also because of the fact that economic life will in all likelihood be shorter than the actual physical life of the equipment. In his report he suggested that the throughput formula was sound for future accounting, and it seems to me that if it is sound for the future it must also be sound as to the past.

On the evidence, there seems to be little importance attached to the ultimate salvage resulting for example when gas lines are out of service, even though physical condition might be excellent. To me that suggests that economic life in terms of service to be performed is the

proper basis for accruing the depreciation requirement, and I would so recommend for all classes of asset whose physical life may be taken to extend beyond economic life.

With regard to auxiliary plant such as boiler plant, electric plant and water plant, physical life may not extend beyond economic life and straight line rates are therefore suggested. The particular formulas used in our alternative submissions are those worked out in collaboration with the engineer appointed by the Board. Special rates are applied to furniture, fixtures and office equipment, and to automotive equipment which are generally in line with general practice.

I should perhaps say here that in my view the depreciation actually recorded on the books of the company is not material, and I should have felt it proper to recompute depreciation whether the booked depreciation were high or low. The question is one of determining fair depreciation, not the depreciation that may have been taken unnecessarily, or was not taken, but should have been taken, by the company.

Generally speaking, the basis I would now recommend to the Board is the last one listed in WH 1a, which gives the net valuation of $1,573,668. I should point out, however, that if on taking into account all factors the Board arrives at a pragmatic or arbitrary amount, it will be necessary for such a figure to be broken down functionally by classes for obvious reasons of accounting.

With regard to the Seaboard plant, I consider that obsolescence as a special factor should be taken into account if reproduction cost is the basis of

gross valuation, but not if historical cost is the basis. The same applies to the special provision for discounting excess operating costs of that plant..

With regard to any relative inefficiency the Board might find to attach to the gathering lines (by reason of absorption plant operation), it appears to me that the rate base should be determined without regard to this factor, which more properly might be dealt with in assessing the proportions of cost to be borne by the absorption plant.

With regard to going value, if we take adjusted historical cost and we take in the Seaboard and the lines at full cost less accrued depreciation, in other words we take the system as a whole, the bad with the good, which eliminates in my view the necessity for going value.

MR. STEER: What was that last?

MR. HARVIE: That was not in the mimeographed copy.

A Oh I see. I have written it in in my copy but it did not appear in Mr. Blanchard's copy. I can give it to you again. With regard to going value, if we take adjusted historical cost and we take in the Seaboard and the lines at full cost less accrued depreciation, in other words we take the system as a whole, the bad with the good, which eliminates in my view the necessity for going value.

Q MR. BLANCHARD: Now, Mr. Hamilton, have you any other comments at the moment to make with respect to these alternative rate bases as set up in your Statement 1a?

A No sir. Statement WH1a is a factual compilation of the results applying the various formulas in rate base determination.

Q Then will you go on to Statement 2 of your submission, which is found at page 11 of Volume 2 and the relative statements in Volume 1 of Exhibit 124?

(Go to page 3651)

Section 2 deals with the utility company working capital allowances and I will confine my remarks to the Madison Company in that connection, the relative statements in Volume 1 Statement W-H-20 and the three charts Numbers 21, 22 and 23.

I read now from Page 11 of Volume 2:

Madison's submission M-9 is predicated on a working capital allowance of $190,000.00 plus prepaid Girbotol royalty commencing at $27,576.38, which should now read $21,501.00 and decreasing at a rate of $4,012.08, which should now read $4,373.70 per annum.

Mr.Smith will check me if I am wrong on them.

Our recommendation in this respect is that the working capital allowance be set at $140,000.00 plus an allowance for prepaid Girbotol royalty on the Madison basis as above mentioned. Our computation of the recommended working capital allowance is contained in W-H-20, and graphs to demonstrate the effect of working capital allowances upon the cumulative cash position of the company are presented in W-H-21, 22 and 23. In connection therewith the following comments apply:

ALLOWANCE FOR INVENTORY OF MATERIALS AND SUPPLIES

Subject to the obaining of engineering advice, the Madison computation of $93,134.16 is adopted herein.

Now perhaps this is the time to refer to Statement W-H-20, and I will read the comments that follow bearing on that statement. I will repeat:

ALLOWANCE FOR INVENTORY OF MATERIALS AND SUPPLIES

Subject to the obtaining of engineering advice, the Madison computation of $93,134.16 is adopted herein, and we were subsequently assured by the Board's engineers that that amount

was reasonable.

Now with regard to the allowance for cash operating expense:

At the foot of W-H-20 we present a calculation of the estimated annual cash expense based on the Madison submission in M-9. Our calculation reflects an average annual cash expenditure of $446,727.76 as compared with Madison's calculation of $451,560.81 as contained in M-7-C; the principal reason for the difference is that we have excluded in our calculation that part of Girbotol royalty expense which has been prepaid. Inasmuch as prepaid Girbotol royalty is the subject of separate claim in which we concur, the exclusion is necessary to prevent duplication, and I believe that was an oversight on Mr. Kirkpatrick's part that there was a duplication there and the point was cleared up subsequently.

In addition to cash operating expenses, Madison will be required to distribute payments to the producers for residue gas, but it is suggested that the producers' contract as finally approved, should stipulate a payment date not earlier than the date upon which Madison receives payment from the Canadian Western Company. Further in this regard, it is proposed that as a matter of convenience, Madison will also distribute for Royalite the producers' share of absorption plant product, and it is submitted that if this procedure is eventually agreed upon, it is the responsibility of the Royalite Company to place Madison in funds prior to the making of such distribution. No provision has, therefore, been made for working capital for either of these two types of payment, and I might say theoretically my recollection of

Mr. Hill's evidence would agree with that.

We have made a careful review of the incidence of expenditure in 1944 on the basis of actual results and find that expenses are incurred at an almost uniform rate throughout the year despite variations in income.

From our examination of detailed analyses of departmental operating costs contained in M-9-B, it would appear that salaries and wages account for approximately $230,000.00 of the total annual cash expense of $446,727.76. Salaries and wages are paid twice monthly, that is, on the 20th of the month, for the period from the 1st to the 15th, and on the 5th of the month following for the period from the 16th to the 31st. As payment is received from the Canadian Western Company for each month's deliveries on the 20th of the month following, it follows that the average waiting period for wages is a minimum of 15 days and a maximum of 30 days, or an average of 22½ days or 1/16 of a year. For the financing of payrolls, therefore, we have provided an amount of 1/16 of $230,000.00 or $14,375.00. It is recognized, however, that this provision does not fully protect the company in the first six week period of the year.

The remaining cash expenses of $216,727.76 represent inventory replacements and sundry services which we assume from our examination to be incurred at a fairly uniform rate throughout the year. Assuming payment to be made coincident with the incurring of the expense, the maximum waiting period would be 51 days and the minimum 21 days, an average of 36 days, or 1/10 of a year. On this basis we have calculated the requirement for cash operating expenses, other than payroll, as 1/10 of $216,727.76, or

$21,672.77.

It is recognized, of course, that in certain cases, payment occurs prior to the receipt of services as for example, insurance , but we are of theopinion that in most cases the reverse situation obtains and that an assumption of payment coincident with the incurring of the expense errs sufficiently on the side of safety, to offset the qualification relating to the first six week payroll outlay referred to in the previous paragraph.

The allowance for inventory of $93,134.16, and for cash operating expense of $36,047.77, result in a total allowance of $129,181.93. Recognizing that requirements computed on an average basis do not cover maximum requirements in the first six week period, we have added a margin of $10,818.07 to arrive at a recommended working capital requirement of $140,000.00; this is, as previously mentioned, exclusive of a due allowance for prepaid Girbotol royalty.

You will observe on Statement W-H-20 how this amount of $140.000.00 is computed. We take first of all the suggested inventory of requirements as contained in Madison M-7-B, that is the inventory of materials and supplies, of ninety-three thousand dollars odd, and to that allow working capital for financing of cash operating expenses split into two parts, so much to cover payroll and so much to cover other cash expenses, a combined figure of thirty-six thousand odd, taken with the inventory requirements, giving a hundred and twenty-nine thousand dollars odd working capital requirement which we have rounded out to $140,000.00.

The Table at the foot of the statement

is a Table to determine the approximate average cash expenses which require financing throughout the years 1944 to 1948 inclusive, and they check very closely with Madison's own submission.

There then follows three charts to show the effect on the accumulated cash position of allowing various working capital accounts from the outset, and before reading from page 14 perhaps we might have a look at W-~~14~~-21 to get our bearings. This chart shows "Time" against "Money". The vertical axis shows the months of the year - pardon me, the horizontal axis shows the month of the year and the vertical axis the various amounts of cash.

The blue line, the purple line at the ninety thousand dollar level represents cash requirements for the basic inventory of materials and supplies.

The green step running up from the lower left corner to the upper right, represents the cash received.

You will observe that no cash comes in until the latter part of February. That amounts to about $100,000.00 which is the approximate amount received from the Canadian Western for the supplying of gas during the month of January. No more cash comes in until the latter part of March, when we have another one hundred thousand odd, again from theCanadian Western, and I should say "any other customers", and so on up. You will notice that the steps vary in their height due to the fluctuation of the volume of sales.

Commencing at the ninety thousand level,on the 1st of January you have a red line projected

inclining upward to a figure of five hundred and twenty-eight thousand at the end of the year, and that red line represents the accumulative outgoings for cash expenses, including payroll, which is superimposed of course, down to the ninety thousand dollar requirement for inventory.

Now then the crux of the matter is the relationship between the two curves, the red line and the green line. Where the red line is over the green line, the Company has in theory an overdraft and likewise when the green line is over the red line, the Company has cash on hand to the extent indicated.

With those explanations I might read from Page 14:

EFFECT OF WORKING CAPITAL ALLOWANCES UPON CUMULATIVE CASH POSITION

In the chart presented as W-H-21, we demonstrate the approximate cash position throughout the year assuming that no working capital provision is made other than a banking arrangement for overdrafts as required. The horizontal axis corresponds to the months of the year and the vertical axis represents cash in dollars. The horizontal line drawn at the $90,000.00 level represents the company's continuous investment in basic inventory and assumes that this inventory was acquired and paid for on the first day of the year. The red line commencing at $90,000.00 on January 1st, and ascending in a straight line to $528,000.00 at December 31st, represents the cumulative outgo for cash expense of $438,000.00 superimposed upon the cash requirement of $90,000.00 for basic inventory. As previously mentioned, operating expenses are incurred at an almost uniform rate,

and we are assuming for the purpose of demonstration that payment occurs coincident with the incurring of expense.

My experience would be, of course, that there is a substantial safety there, which lends strength to that statement.

The irregular green line represents the cumulative total cash received for sales and external charges, less that portion of sales proceeds which is to be passed on to the producer. It is assumed, for convenience in demonstration, that these receipts are recovered for each month approximately 3/5ths of the way through the month following. It will, therefore, be observed that the first cash received is in the latter part of February and that the company is, therefore, in overdraft until the latter part of March, and again for a short period and for a small amount in the early part of April. Thereafter, cash collections outstrip cash payments, so that by December 31st the company should have on hand in cash $277,000.00 in excess of outstanding expense accounts payable. One further month's cash receipts have yet to be recovered in January of the next year amounting to approximately $115,000.00, by which time the excess of receipts over payments applicable to the year would amount to $392,000.00, which corresponds to the total depreciation and yield contained in the Madison submission M-9-A/44, less the $90,000.00 investment in inventory.

I should suggest this qualification at this point, and that is that this Table W-H-21 and the two which follow, do not give effect to the outgoing for Federal income tax and Excess Profits tax, which, as you will recall, are paid on the instalment basis commencing for the year 1944, for example, on July 1st of 1944, and in twelve monthly payments

thereafter, commencing halfway through the year's taxes and extending halfway into the next year, so that the effect of the taxes would be to skim off part of the surplus cash from the mid-year on. It would not affect the critical first half of the year.

Q MR. BLANCHARD: Your Chart 21 is based on the 1944 operating expenses?

A Yes.

Q It is not on the average?

A Based on actual 1944 because we had a case there of the rate at which the expenditures were made. The Table W-H-21 was based on a basic inventory of ninety thousand dollars and I am reading now from the head note to that chart, with cash expenses paid daily as incurred, which, of course, as I mentioned before, lends a safety factor; thirdly, that the revenues are received approximately on the 20th of the month following, and finally after any working capital allowance has been made. In other words, they start with nothing and that gives an overdraft in the first two or three months of the year.

W-H-22 and W-H-23 have been prepared on the same basis as W-H-21 to demonstrate the effect upon the cumulative cash position of the company, assuming opening working capital to be provided in the amounts of $190,000.00, that was the Madison suggestion, and $140,000.00 which was ours respectively. It will be observed that an allowance of $190,000.00 working capital at the beginning of the year precludes any serious risk of overdraft in the early part of the year, and during the remainder of the year represents from time to time that much additional surplus funds. The provision

of $140,000.00 original working capital results in a theoretical overdraft of short duration and of insignificant amount during the month of February, but we are of the opinion that the normal lag in payment would automatically prevent this condition from actually arising.

Then, Sir, I follow with some special comments regarding special features.

With regard to the financing of Capital Additions:

No provision has been made herein by way of working capital for the financing of future capital additions. We are of the opinion that expenditures in respect to capital additions should be admitted to the rate base from the year of expenditure rather than from the year of coming into service, and if this principle is acceptable, it follows that:

1. No additional provision need be made by way of working capital in this respect.

2. The company receives its due return upon capital expenditures as from the average dates expenditures are incurred.

3. The consumers' interests are protected on a basis not inconsistent with a broad interpretation of the "used and useful" rule for rate base determination.

With regard to provision for emergent expenditures and contingencies, the principal element of difference between the Madison working capital recommendation of $190.000.00 and ours of $140,000.00, is provision for contingency funds which in the Madison submission M-7-C amounts to $43,554.90

A That is on the 15.6 rate suggested by the Company. I would just like to emphasize once again that these three charts do not include provision for payment of income and excess profits tax which will affect only the second half of the year and tend to skim off part of the cash funds on hand . It will not affect the cash position in the first six months which of course is the critical period.

MR. McDONALD: Mr. Chairman, I was wondering whether we should not deal with the rate of return so that the rate base and the rate of return could be included in one cross-examination ?

THE CHAIRMAN: I prefer to keep them separate. The record is rather badly shot up until now and if we can keep it in more or less water tight compartments as to the various subjects I think it will be a help to all of us.

CROSS-EXAMINED BY MR. CHAMBERS:

Q Mr. Hamilton, as I understand it the effect of Exhibit 125 which you read this morning is that you recommend the Board fix a rate base for Madison of $1,713,688.00 of which $1,573,688.00 is in respect of fixed plant and equipment and $140,000.00 for working capital. Is that right ?

A Plus allowance for pre-paid Girbotol royalty.

Q How much would that be, $25,000.00 ?

A Approximately $21,500.00.

MR. BLANCHARD: That is the present amount. What was the amount as of the date ?

A That would be as I take it January 1st, 1943.

Q MR. CHAMBERS: Yes, that amount would be how much ?

A $21,501.00.

Q So that would make a total of $1,735,189.00 ?

A I have it $1,735,169.00, if it makes any difference.

Q All right, I will take that.

THE CHAIRMAN: What is that figure again ?

A I make it $1,735,169.00.

Q MR. CHAMBERS: $1,735,169.00 ?

A Correct.

Q As at the first day of January 1943 ?

A 1943, yes sir.

Q And I take it that from this Exhibit 125 you are giving to this Board as your sworn opinion that that amount of $1,735,169.00 will be a fair and just and equitable rate basis. Is that right ?

A Yes sir. I am not saying sir that is the only fair rate base that might be adopted. That is my idea of a fair rate base. I would not quarrel with a figure that was even $100,000.00 or $200,000.00 either way. That is my idea of the closest proximate you can get to fairness.

Q Now Mr. Hamilton, in the first instance more for the purpose of making a reconciliation on the record in case you want to refer to it again, I would like to examine briefly with you some of the statements in Volume 1 of Exhibit 124, and I will ask your indulgence. I will give you some figures. I do not suggest you do the figuring here but if there is anything wrong with them later on you can let me know. Now as I understand it WH 2 is in effect this, reproduction costs as per Hill and that is based on around November 1943 ?

A Yes sir.

Q According to Hill's Exhibit 59 the valuation of the physical plant and equipment was $2,538,157.75 ?

A Well the actual amount.

Q That is the cost new ?

A That is after return fuel line is out ?

Q Yes.

A Yes sir.

Q And Hill in his Exhibit 59 had Girbotol royalty in at $29,974.38?

A Something of that order.

Q And then he had $200,000.00 for going value and he had $190,000.00 in for working capital ?

A Yes sir.

Q Now on that basis, so he had cost new according to Exhibit 59 of $2,958,132.13 ?

A Excuse me a moment. May I have that figure again please.

Q $2,958,132.13.

A I just do not get that.

Q Maybe you have this figure, $2,980,216.00 ?

MR. BLANCHARD: That is Page 22, M-6, Exhibit 59 ?

MR. CHAMBERS: Yes.

A Well I am looking at Exhibit 120 which starts off with Exhibit 59, Page 22. I assumed that this picked up the values finally adopted in Exhibit 59. I am speaking of 120, the Exhibit prepared and submitted through Mr. Stevens-Guille.

Q Well I find on Page 22 of Exhibit 59, have you that in front of you ?

A No, I have something that is supposed to relate to Page 22, and is so described.

Q And then he adds the $200,000.00 going value. We will run into that $40.00 again. Mr. Hill applied .89 to each item which makes a difference of about $50.00 or $60.00. Well in any case I notice on Exhibit 59, Page 22, that the total net depreciation

figure of Mr. Hill for the items that I have mentioned is $2,958,216.00 ?

A Substantially so including overhead, Girbotol prepaid royalty, working capital and going value.

Q That is right ?

A Yes sir.

Q Now then taking the same thing but allowing for Hill's observed depreciation, we get these figures from Exhibit 59. The depreciated value of the physical plant and equipment he had $2,070,085.87 and Girbotal royalty he had in at $27,576.38, depreciated and going value $200,000.00 and the working capital of $190,000.00. In other words we get a depreciated amount of $2,487,704.00 ?

A Substantially right.

Q That was Mr. Hill's valuation or recommendation in Exhibit 59. Then by Exhibit 60 there were certain adjustments made by reason of other things that had come to light. You will recall that. As I understand the effect of Exhibit 60 Mr. Hill adds $45,886.00 to his reproduction costs new as shown on Exhibit 59 and gives us a total cost new of $3,004,102.00 ?

A Yes, bearing in mind that the Hill adjustment of $45,000.00 odd to which you refer is a net adjustment.

Q Yes.

A That takes into account plusses and minus.

Q Yes, and then he ends up when he comes to apply that adjustment to the depreciated value, he adds a net of $40,260.00 which gives a depreciated value as at November 1943 of fixed plant assets, $190,000.00 working capital, Girbotol royalty and going value of $2,527,964.00 ?

A Yes sir.

Q Then let us go one step further in order to bring it down to date. Then by applying Exhibit 120 to the combination of Exhibits 59 and 60 the reproduction costs new still remain at the $3,004,052.00 but we take off $83,976.00 from the depreciated value. Do you recall that ?

A Close enough sir within a few dollars.

Q Which would leave the value of the entire rate base after allowing for that further deduction of $2,443,988.00 ?

A When you say that further reduction you mean -

Q The $83,000.00.

A Contained in Exhibit 120.

Q Yes.

A Yes sir. Not to be confused with the further reduction which I was suggesting arising out of that.

Q No. In other words, as I take it Mr. Hill says that if you were building a plant today it would cost about $2,538,157.00.

A Pardon me sir.

Q That if you were building a plant today and I am referring now to the physical plant, that it would cost about $2,538,157.00.

A I did not get that figure.

Q By the way I arrive at that is this, Mr. Hill in his Exhibit 59 used the reproduction cost new ?

A Yes.

Q And in his first column on Page 2 gives the cost of it new today, 1943 ?

A Yes.

Q And he says that figure is $2,538,157.75 ?

A That includes the Girbotol prepaid royalty does it not.

Q I am sorry.

A I would think sir that Mr. Hill's reproduction cost new after

into account the various adjustments suggested would be within one hundred dollars of $2,592,500.00. Would that not check ?

Q Well I notice you have not Exhibit 59 in front of you ?

A No I have 120, which is -

Q On Page 22 of Exhibit 59 he gives in the first column the estimated cost of reproduction as at November 1943. He lists the various items and he gets $2,356,116.00. He adds the general overhead and he gets $2,558,216.00 ?

A Yes sir, but that includes the Girbotol royalty. I think you will find it in the figure of gas purifying plant, $685,000.00.

(Go to Page 3666)

Q All right, then we should take from that figure of $2,568,216 the Girbotol royalty of $21,501.

MR. BLANCHARD: In Exhibit 120 that figure is Girbotol royalty, $19,726. How is that reconciled?

A That is after adjustments, sir. I think you can take it, subject to working it out by Mr. Smith, that Mr. Hill's final determination of Reproduction Cost New, gross values of the physical plant, excluding going value, working capital and Girbotol advance royalty was very close to $2,592,511.

Q MR. STEER: I would like to know how it is made up. WH 2, of your Volume number 1, you have Girbotol advance royalty $29,974.38.

A That is reconciled in WH 2a. At the foot of WH 2a there is a reconciliation of the final figure of ours which we take it to be Mr. Hill's, with Mr. Stevens-Guille's figure in Exhibit 120, page 2.

Q MR. CHAMBERS: Let us then turn to Exhibit 120.

Q THE CHAIRMAN: Is this not broken down in your WH 2? WH 2 is before adjustments?

A Before adjustments in the Girbotol and in the sundry unit increases suggested by Mr. Hill on the order of $50,000. Exhibit 120 does give effect to those adjustments but you have to exclude from them the going value, working capital and prepaid Girbotol royalty and you get back then to a figure of $2,592,511.

Q MR. CHAMBERS: $2,592,511?

A Yes, according to our WH 2a.

MR. HUMPHRIES: We have 551.

A That is right.

Q MR. CHAMBERS: Now those same assets, according to your

Exhibit 124, page 3 of Volume 1, the cost . . . . .

A Statement 3, I think you mean and not page 3.

Q WH 3.

A Yes.

Q The cost according to the books is $1,930,971.77.

A If you mean as shown by the books.

Q Yes.

A Those are the amounts appearing in those accounts.

Q Yes.

A A complete examination of the books would probably find the cost somewhat different from that.

Q And the book depreciation against those assets was $1,141,322.96.

A As of December 31st, 1943.

Q That is right.

A Right.

Q Now then I wonder if you would follow me through this reconciliation on Exhibit 120. Take Reproduction Cost New of the physical assets and allowing 9% overhead. From the second-last column there is a total figure of $2,398,213 and we take off the Girbotol royalty $92,726 and it leaves us $2,378,487. But they have not added the 9% overhead. If you add the 9% overhead, that is an amount of $214,061 and we end up then with that figure of yours $2,592,551.

A Yes sir.

Q Then we take Hill's observed depreciation off of $560,064 and we end up with a net of $2,032,487, is that right?

A Your last figure was?

Q $2,032,487.

A Approximately.

Q And I suggest that checks with your supplement that you put

in yesterday.

A Yes sir.

Q Now reverting for a moment to WH 2b, I take it that you suggest that if the Board were to adopt the reproduction method of valuation that by reason of this $7500 additional operating cost of the Seaboard over the Girbotol that the value of the scrubbing plant as shown on Exhibit 120 should be further reduced by $76,740, is that right?

A That there should be a reduction. Whether that is the appropriate amount or not depends on the assumptions.

Q But you, in WH 2b, give us a figure of that amount.

A $76,740?

Q Yes.

A Geared to certain assumptions which are first set out.

Q I am trying to explore your idea. You apparently must have had something in mind that the matter would be of interest to the Board.

A Yes, quite.

Q I would like to have your views as to that situation assuming the Board was giving consideration to reproduction cost.

A Yes sir.

Q What would you suggest in that regard?

A You are enquiring now as to why it is suggested that an adjustment of this character should be made.

Q Yes.

A Or as to whether an adjustment should be made.

Q Whether it should be that amount or something in the neighbourhood of that amount.

A But first of all as to whether an adjustment should be made I take it.

Q Yes.

A I understood Mr. Stevens-Guille's evidence to be that the Reproduction Cost New valuation had been subjected in Exhibit 120 to a special obsolescence allowance to arrive at a depreciated value of $189,230 plus an allowance for overhead because the Seaboard plant was considered to be subject to obsolescence in relation to the more modern Girbotol plant and the Seaboard valuation net was arrived at on the basis of the comparable value or cost of a complete Girbotol unit. But the fact of the matter is that you have not got a Girbotol and you therefore still have got the Seaboard. Mr. Stevens-Guille's evidence was that continued operation of the Seaboard involved more expenditure from year to year than if you had actually transposed the Seaboard plant and replaced a Girbotol. To my mind that suggested that the responsibility of paying out the additional $7500 over and above what you would have paid under alternative circumstances places a further discount on the value of the Seaboard.

THE CHAIRMAN: I think this would be a suitable time to adjourn for a few minutes.

(At this stage there was a short adjournment taken.)

Q MR. CHAMBERS: Now, Mr. Hamilton, assuming that we did deduct the $76,740 shown on statement WH 2b from the Seaboard valuation as adjusted by Exhibit 120, we would have an amount left of $112,235. I arrive at that figure in this way. Exhibit 120 shows the Seaboard unit at $189,230.

A Yes sir.

Q And then we take $76,740 off that and we get $112,590.

A Yes sir.

Q Exhibit 120 shows that it would cost $110,235 . . . . . .

A I did not get the last. I wonder, Mr. Chambers, the $189,230 you are using is before adding 9%. You are bearing that in mind are you?

Q Let us discard that for a moment. I am going to illustrate the principle I am coming at and that will not make any difference.

A All right.

Q Thank you for calling it to my attention. The company in order to arrive at that result we would have $110,235 spent and I suggest that only leaves $2,355 for that substantial portion of the Seaboard that is going to be used. In other words, if you deduct another $76,740 that in effect we are taking in that portion of the Seaboard which is used and useful, and up-to-date, as I understand it, at $2,355. Is that not so?

A What was the figure you mentioned? $3000?

Q $2,355.

A Now one moment. What was the amount that you suggested to me as being the amount actually spent?

Q $110,235. That is on page 12 of Exhibit 120.

A As a result of these various assumptions I would place a value of $19,286 on that portion which presently exists.

Q How much?

A $19,286.

Q Would you tell us how you arrive at that?

A The difference being, subject to my rapid calculation, a difference of $17,031 relating to the 9% applicable to the total of $189,230 as the depreciated Seaboard valuation that you asked me to start with. If I can assist you, on page 2 of Exhibit 120 against the Seaboard plant you

have a depreciated value in the last column of $189,230. To that you must add 9% which gives you $206,261, from which you subtract $76,740 and gives you a residue of $129,521. Then you ask me to deduct from that, or from some such figure $110,235 as being fresh expenditure required for conversion and the residue then would be $19,286 which would be the valuation placed on the existing assets which would enter into that conversion.

Q Would you not have to also take 9% on the $110,000 in that case too? Because the $189,230, as I understand it, includes the $110,235, and there is no 9% on that.

A That is probably so, sir. I am probably wrong in that but I would like to think about it though.

Q And according to Mr. Hill's valuation and analysis made in Exhibit 120, the present reproduction cost of that portion of the Seaboard that was used and useful, even on a converted basis, is $78,995, before the 9% and after allowing depreciation.

A On the observed basis.

Q Yes, on the observed basis. Now just as a matter of interest I think you also told us yesterday that figure of $76,740 would vary up or down as you changed the factor.

A Yes, any of the assumptions on which it is based.

Q If the factor was 10% the higher the factor the lower the result is.

A The higher the rate of interest the smaller the adjustment and the shorter the term of years the smaller the adjustment.

Q In your Exhibit 125 didn't you refer to the fact that there was functional depreciation in the Seaboard?

A I took it to be so, sir, yes.

Q Do you recall that Mr. Hill, I think it was in answer to Dr. Boomer or the Chairman, disagreed that there was functional depreciation in the Seaboard?

A I think that is a matter of terms, sir, depending on what you mean by functional depreciation.

Q Well, my understanding of the evidence of both Mr. Hill and Mr. Stevens-Guille was that the Seaboard was doing the job efficiently of taking sulphur out of the gas.

A That is so, I believe.

Q My understanding of functional depreciation is that a piece of equipment is not doing the job that it was designed to do or that some other piece of equipment might do.

A Not necessaridy, sir. The term "functional depreciation" is very broad in its application and it covers loss in service value of an asset from any cause other than physical causes, wear and tear and any other economic factors, grouped under the heading, in general parlance, of the term "functional depreciation."

Q I suggest to you that the definition you have just given us is really a definition of what we call obsolescence.

A As I said before, it is a matter of terms. I take the term functional depreciation to cover all the known physical aspects of depreciation in its broadest sense, of which obsolescence is one factor, supercessional is another and inadequacy is a third.

Q Probably we can be at one in this, that where you use the term functional depreciation you use it in that broad sense?

A In the very broadest sense.

Q It does not necessarily imply that the mechanism of the equipment is not doing the job properly?

A Not at all, sir.

Q What would think of this proposition, Mr. Hamilton, with regard to the Seaboard? I am talking now about reproduction cost. That if you are going to take operating expense into account as an item of obsolescence or depreciation, that the present day value of that Seaboard would be something like this: - According to Exhibit 120, page 2 I think it is, the cost of the Seaboard new is $428,396.

A That is not the cost, that is the reproduction cost.

Q Yes, that is what I am asking you to examine.

A Yes, plus 9%.

Q I am going to bring that in a little later. Then there was depreciation of $162,119, which left Mr. Hill's valuation of $266,277.

A Pardon me, I have not got that figure.

Q It is half-way down the third last column, $266,277 on page 2.

A Yes.

Q Do you see the item, the third last column about half-way down, $266,277?

A I have it now.

Q Then according to your statement WH 2b, you take off another $76,740 that Hill did not allow for which leaves $189,537 and we have not taken the 9% into the picture at all. So now we add 9% on, which is $17,100 and we get a result of $206,637. What do you say as to that being a reasonable or proper way of assessing the present-day value on a reproduction cost basis of the Seaboard and allowing for obsolescence?

A If you will give me your calculation again, I can follow your principle.

Q The cost of the Seaboard unit in 1943 would be $428,396.00 according to Exhibit 120.

A Yes.

Q And Hill allowed depreciation of $162,119.00, that does not show?

A But we got that figure.

Q Yes, Hill's depreciated value was $266,277.00?

A Yes.

Q That means he allowed that difference of $162,119.00 as observed depreciation?

A Yes.

Q Now my suggestion is, by reason of your statement W-H-2-B we should subtract for obsolescence another $76,740.00, which leaves $189,537.00?

A I follow you.

Q But the 9% overhead has not been included and that probably should be, for the purposes of our proposition, and that item would be $17,100.00, which should be added, which would leave a total depreciated value as at November 1943 on a reproduction cost basis of $206,637.00, if the Board were considering present day value on a reproduction cost basis, what would you say as to that being a fair approach to the Seaboard?

A I have two comments in that regard, Mr. Chambers. First of all, under the operation I am not in favour of the premises which you suggest. I rather doubt whether the 9% should apply to the $76,000.00 deducted because there needs to be no overhead allowed to that type of operation in other words I think you could take your $266,277.00, then add 9% and then subtract the $76,740.00, which would give you a somewhat higher figure.

Q Yes, a higher figure.

A But on the other hand, and I think this is possibly of much more significance, and that is that the deduction of $76,740.00 is the present value of an expense differential of something in the order of seven or eight thousand dollars, suggested by Mr. Stevens-Guille, which as I recall represented one man per shift for three shifts a day, and does not take into account the fact that the Seaboard involves a plant having a reproduction cost value of something almost double that of the Girbotol, and consequently again I would assume additional maintenance, because there is more actual equipment there, and secondly it does not take into consideration the fact that the Seaboard is an older plant; in other words, the $76,740.00 deduction bears only with respect to the increased or the excess payroll which is involved and does not take into consideration any other aspects of expense.

Q No, but I undestood Mr. Stevens-Guille to say, and I am asking you to assume this for this proposition, that the difference in operating expenses was between seven and eight thousand dollars and he did say that the larger part of it was a one man shift, but he did not, as I recall it, say "all", but I am asking you to assume that that is the total difference in operating expenses, would you think that that would be a reasonable approach?

A Offhand I think it would depend to a very large degree on the principles that were in mind when the two factors which have already been allowed were allowed, namely, what consideration operated in Mr. Hill's mind to suggest a reduction of reproduction costs new from $428,396.00 to a depreciated value of $266,277.00.

Q Well I think you will recall that Mr. Hill, in his Exhibit 59,

did depreciate the Seaboard unit substantially?

A Yes.

Q Now what I am getting at is this, Mr. Hamilton, my understanding of the evidence, and I am asking you to assume it for the purposes of this question, that the Seaboard plant so far as its mechanical operation is concerned, is functioning and doing the job, and it was part of the equipment in Turner Valley, and then along comes a statute, The Natural Gas Utilities Act, that devotes that property to the public service and it is that plant down there, - not another plant, - and that is the property which has to be valued and I am suggesting to you, assuming the operating expenses, or the total operating expenses are not more than something between seven and eight thousand dollars, and assuming also that the Seaboard is doing the mechanical operation, that if we take reproduction or present day value of reproduction, that the $206,637.00 would be a fair figure?

A I do not think so, Mr. Chambers.

Q All right, will you give us your reasons?

A Yes. Without thinking it through fully, this being more or less of a snap answer, I am impressed with the fact that the Girbotol plant reproduction new is, I think, $258,956.00 before overhead, whereas the Seaboard was $428,396.00, almost double we will say. Now let us assume for example that to have constructed the Seaboard it costs four million dollars instead of $400,000.00, then a mere reduction by the seventy-six thousand dollars would not bring the final value into anything like a comparable value of a Girbotol unit which would do the job with equal satisfaction.

Q Yes, but in answer to that I say to you for the purposes

of this discussion that the Legislature has, in effect, said "it was the Seaboard plant we want and not another one".

A Quite true, and we are now trying to find a fair value for the Seaboard.

Q Well how much more, if anything, do you think should be deducted from this two hundred and six thousand figure?

A I suggest that there are two distinct types of deductions, - one, is to get the Seaboard down to the Girbotol basis in physical terms, and secondly, to take into account those excess operating costs, if there are any, of operating the Seaboard plant which you have, as compared with the operating costs which you would have if it were a Girbotol.

Q Now will you direct your attention.....

A That again, Mr. Chambers, is solely on the basis of the reproduction value approach. I make no suggestion that we adopt it.

Q I understand, and bear in mind I am just asking these questions more for purposes of the discussion because something may come out of it?

A I do not want the impression to be created that this type of adjustment would be recommended under all circumstances. It is only on the one approach.

Q Yes. The total operating expenses of Madison were roughly, can you tell me offhand what they were? About four hundred thousand, the direct operating expenses?

A The total operating expenses of Madison altogether?

Q Of Madison?

A And the scrubbing plant?

Q No, of the whole thing? First of all the whole thing and then the scrubbing plant, if you do not mind?

A Those are rather difficult to give to you, but I will try. Four hundred and thirty-eight thousand, I believe, was the figure, was it not, that I worked out once before.

MR. HARVIE: Four hundred and sixty thousand, was it not?

Q mr. chambers: Anyway, as I understand it it would be around four hundred thousand dollars?

A Yes, roughly that.

Q And the scrubbing plant is what, is around one hundred thousand, or around two hundred thousand?

A Not quite that high, but it is getting up there.

Q Well yes, a hundred and eighty-six thousand, something around there; now I am suggesting to you, Mr. Hamilton, as an auditor and chartered accountant with experience in dealing with the accounts of companies of substantial sizes, that a seven to eight thousand dollar difference in annual operating expenses is a pretty small percentage on an estimate?

A Quite true.

Q And that in an operation of this size, that the Board or any other party in assessing a valuation on this basis of reproduction costs, should not, on an estimate of an engineer, no matter how good he is, arbitrarily say that a unit should be reduced in value by seventy-six thousand dollars because there might be, - there might be, - a different operating cost in that connection, what do you say to that?

A Just that I have considerable respect for Mr. Stevens-Guille's judgment, he says it is going to cost seven or eight thousand dollars more.

Q But it is still an estimate?

A It is still an estimate.

Q And it is predicated on events which happen in the future?

A That is correct.

Q And you know, I think, from being here and probably through examining the books, that the installation of the Girbotol in Turner Valley did not automatically open up a new millenium, in other words there were considerable unforeseen expenses?

A I understand so, yes.

Q Yes, and I think the evidence was given here and I think you heard it maybe, and if you did not I do not ask you to agree to it, that the company's engineers have a feeling that in the long range, there is an element of safety in having the Seaboard, something which has been proven?

A I have no knowledge of that.

Q Have you known that that is a serious suggestion?

A No, it has not been suggested to me.

Q Well assuming that, assuming that the Board should be satisfied by evidence that the Seaboard unit, because it was known and proven, became an element of reliability, that we could not reasonably allocate to a wholly owned Girbotol, I mean a wholly constituted Girbotol, now assuming that was so, merely because there was this difference in operating expenses of from seven to eight thousand dollars, would you say that the Board should deduct seventy-six thousand dollars by way of obsolescence?

A If it was a qualified engineering opinion that it were worth while to operate a Seaboard and a Girbotol in conjunction and that by so doing the insurance lent by the presence of the Seaboard outweighed the excess operating costs and that over-all it were advisable to operate the two together, then I would not suggest it was excessive, no.

Q You will agree with me, I think, that in the supply of scrubbed

gas to the Gas Company continuity at all times is of prime importance.

A The supply of gas, yes.

Q Yes, and without any interruption, that is a matter that the consumers ask for, is it not?

A Yes.

Q And expect?

A Yes, it is a matter of extreme importance.

Q And if the consumer asks for that he expects to pay for it, or someone expects to pay for it, that would follow?

A I presume so.

Q Yes. Now, I am putting it to you that if in the opinion ofthe engineers in charge of this operation, they say that it is good business to retain the Seaboard because "we know on its record that it is capable of doing certain things and we have on the other hand had certain troubles with the Girbotol which lead us to think that there are certain things that are not known and that we may have more trouble", now assuming that were so and the Board were convinced of that, you would not suggest that this further seventy-six thousand should be deducted, would you?

A Oh, no sir, the question answers itself in the very same way that if the engineers say "we need a fire engine in there" then we have to have the fire engine and we have to pay for it.

Q Now I would like to direct your attention for a moment to this matter of book depreciation, and I am goinginto it, not merely because I have lined up questions on it, but some other part of the Hearing may, - although you have not made the suggestion that book depreciation should be used, - now, Mr. Hamilton, it is my understanding that down to 1927 at least the Income

War Tax Act, and I think it was Section 5(a), provided that for the purposes of the Act that income taxes therein defined and I am quoting, should "be subject to the following exemptions and deductions", you recall that?

A That has a very familiar ring, yes.

Q And among those enumerated statutory deductions were these, and I am quoting again:

"Such reasonable amount as the Minister in his discretion may allow for depreciation".

You remember that?

A That is as it stood in 1927.

Q In 1927?

A Yes.

Q You remember that Section 5(a) stated that:

"Income taxes under this Act shall be subject to the following deductions."

and one of them was:

"such reasonable amount as the Minister in his discretion may allow for depreciation."

Then you are familiar with the Pioneer Laundry case.....

A I was just going to say that referred to the Pre-Pioneer Laundry era.

Q And the Pioneer Laundry case, as I understand it, arose under circumstances something like these, there were several companies in British Columbia that transferred their assets to a new company, that is so, is it not?

A Yes.

Q And the shareholders of the old company got shares in the new company?

A Yes.

Q And the Minister ruled for the purposes of the income taxes of the new company, that they could not take any more depreciation than had remained on the books of the old companies?

A That he would not allow any more.

Q That he would not allow any more for income tax purposes?

A That is correct.

Q And the Privy Council, in the result, held that the Minister was wrong in that particular case?

A My recollection was that they held that he had exercised reasonable discretion.

Q But do you not recall that they said that under the Statute as it then stood the taxpayer was entitled as of right to a reasonable deduction for depreciation?

A As it then stood.

Q Yes, as it then stood, and as a result of that decision there were certain changes made in the Act and you remember there was another section, and it is yet in the Act, the amendment was to take the matter of discretion out of Section 5 where it allowed exemptions and put it into Section 6, do you remember that?

A Yes.

(Go to page 3683)

Q And Section 6 you remember starts off with, "In computing the amount of profits or gain to be assessed a deduction shall not be allowed in respect of" and one of the things is that depreciation except such amount as the Minister may in his discretion allow. Do you remember that ?

A That is so, sir.

Q In other words by reason of the change in the legislation following the Pioneer Laundry case the Minister has much more to say about depreciation than he had before. Is that not a fair way to put it ?

A That is a fair statement. That was certainly the intention of the Legislature no doubt.

Q Now if my understanding is that in 1933 I think it was, the Minister of National Revenue made a ruling about this matter of depreciation and that ruling reads like this, that the maximum depreciation allowable in any period shall be the amount incorporated in the usual books of records of the tax payer provided however the said amount to be allowed shall not exceed the amount allowable under the rates prescribed by the Income Tax Division." Do you recall that ?

A I understand there is such a ruling in existence.

Q By the way for ready reference that ruling is quoted on Page 23 of the appendix in Gordon Income tax cases ?

A It is a rule that is invariably followed.

Q Yes, but you will observe in that case or in that ruling the taxpayer cannot for income tax purposes deduct any more in depreciation than he shows in his annual statement ?

A Roughly so sir subject to qualifications they will allow you in current year depreciation. You may have claimed in the previous year and they disallowed you but substantially you

are right.

Q And then about the same time another ruling was made by the Department and in that ruling the Department laid down or set up rather a schedule of rates for annual depreciation on different kinds of property. Do you remember that ?

A Yes sir.

Q And I think the annual rate for machinery and plants and so on was 10% ?

A Generally 10% subject to special conditions.

Q So what I am suggesting is that as a result of those two rulings and the change in legislation following the Pioneer Laundry case that any company for Income Tax purposes that wants to get 10% the maximum allowed by the Department for depreciation, it must book them in its books of account ?

A Right.

Q Now then aside from the question of income tax, the amount to be set aside by a company in any year for depreciation depends solely upon the discretion of the Directors as representatives of the shareholders ?

A Primarily, I would not say solely.

Q Would you tell us if you have any reservations ?

A There might be circumstances under which their failing to provide depreciation, dividends were paid against the wishes of minority shareholder groups and by reference to the Court they could force the Directors to do it.

Q Oh yes.

A But primarily it is in the Directors to say how much to set aside.

Q And aside from the amount of income tax that might result there is nothing to prevent Directors from depreciating the

entire capital assets in one year if they see fit ?

A None whatsoever. Pardon me, unless a minority group find that their rights to dividends were thereby impaired. They might proceed to the Court to show that depreciation was taken in excess of requirements. I do not know whether they would succeed or not but I can visualize the circumstances.

Q Under which someone might try it ?

A Yes.

Q But is it not so that Directors so long as acting bona fide have absolute control of the management of the company ?

A You are taking me into a field of law that I do not feel qualified to speak upon but I can visualize circumstances by which they would not be exercising proper discretion in setting aside too much depreciation but in wide limits they have almost whole control over the amount to be set aside.

Q And are you suggesting if they did that the minority shareholders would be able to stop them ?

A You suggested if they wrote off the entire amount in one year.

Q I am also suggesting to you Mr. Hamilton that there is nothing to preclude Directors from applying all the company's earnings less operating expenses and taxes to or on account of depreciation if they see fit ?

A With the same reservation it would have to be within reason.

Q I will accept that reservation on all these answers.

A Yes.

Q And the more the Directors advise it should be in the year the less money there is available for dividends to the shareholders naturally. Would that not be so ?

A The less profits are reflected, yes. Whether it reflects the amount available for dividends is a legal question.

Q Aside from the legal technicality you as an auditor familiar with the books of companies, would you not say that the more money that the Directors in any year applied to depreciation the less monies there are available for dividends in that year ?

A Not necessarily, sir.

Q Well ?

A We are again in the field of law but I have just a sufficient glimmering of it to indicate to me a substantial discrepancy there. In the payment of dividends you are required to survey the condition of the surplus account, not necessarily this year's profits, and secondly you must have regard to the cash position of the company.

Q No, but what I am saying is, available for dividends. You have heard that term used in a commercial sense ?

A Perhaps I can go this far with you. It may be far enough. The more depreciation you write off the less is the resulting profit, but what the effect that has on dividends is another matter.

Q Accumulative profit ?

A Are one of the sources of dividends.

Q Are the main source of dividends ?

A Yes under normal conditions, but not necessarily the only source.

Q Are not profits or accrued or accumulative profits ?

A You are speaking of current earned profit ?

Q I mentioned profits or accrued profits I said ?

A Oh there might be capital gain or retirement of capital.

Q Oh you are talking about capital dividends ?

A In the guise of current dividends, not earmarked as capital distribution at all perhaps.

Q But in any case you would say that the more money that the Directors set aside for depreciation the less would be profits available for that year for dividends ?

A Generally speaking, yes sir.

Q Now if a company is expanding or carrying on new developments instead of obtaining additional capital funds required by say new issues of shares or by borrowing, it is often I suggest considered a sound policy for the Directors to provide substantial depreciation reserves to current earnings ?

A I would agree with you if that were to be broken into two parts and if you were to say that it is customary for a Directorate to provide substantial depreciation reserves in the interests of conservatism. And secondly it is to say that it is frequently the case for Directors to choose capital expense out of plowed back profits.

Q Especially if the Company is engaged in new developments ?

A Yes sir, I am not necessarily agreeing it is proper to consciously overstate the depreciation so as to indirectly provide the Directors with money for expansion. I think the two things must be divorced and dealt with separately.

Q Now if they do that, if they are Directors of a company that is engaged in development work decides to take substantial depreciation those reserves are usually held in liquid form for reinvestment in plant and equipment. That is often done is it not ?

A Yes sir.

Q And it is quite recognized as good practice in certain kinds of businesses is it not ?

A That is reasonable depreciation.

Q Oh yes.

A Yes sir, yes sir.

Q And when I am referring to that I am referring - let us take the 10% ceiling that the department works on. You would say that what the department allows is a fair test of reasonableness ?

A I would think so and when I say reasonableness I would still use that term to cover depreciation provision that might be even two or three times what the theoretical optimum figure might be. You are going to keep on the conservative side and I think it is proper that you should do so.

Q Is that not in effect what the Royalite Company did ?

A I do not know sir. I know that the depreciation allowance that they took was the maximum allowance for income tax purposes and I would assume from Mr. Hill's evidence that the depreciation they took was in excess of the theoretical requirements, but why they did it I would not care to say. I would assume it was for tax purposes.

Q Would this be a fair deduction that if lesser amounts had been credited to depreciation reserves in past years there would have been greater amounts in Royalite's surplus account available for dividends ?

A I would agree with you except the last phrase, available for dividends. Obviously the less depreciation you charge off the greater surplus account will be. What effect that has on dividends I would not say.

Q When I use the term, available for dividends, I am using it in this sense, Mr. Hamilton, that it is money which the Directors under the law can properly pay out to the shareholders if they see fit ?

A I just want to establish at this point which I am sure is in

your mind too, that whether the depreciation allowance in a given year that they choose to fix is high or low has absolutely no bearing whatsoever on the amount of cash that is there.

Q But is this not so, that the Directors of a company can if they do not have the cash on hand borrow money to pay dividends. Have you seen that done in your experience ?

A Yes I have and I have seen them distribute cash when they have no surplus.

Q And then impairing capital ?

A Quite and it might still be a legal dividend I am informed.

Q That would be the case in a certain particular kind of company, mining companies and companies of that kind ?

A Every case has to be taken on its merits I am informed.

Q Now would you agree with me on this that Royalite book depreciation reserve of $1,141,322.96 shown on WH 3 of Volume 1 of your Exhibit 124 has no relation whatsoever to the physical deterioration of the plant ?

A It has a relation but not necessarily a close relation. You say no relation whatsoever. I cannot go that far.

Q To the physical condition of the plant ?

A If there was no depreciation physically there would be no right to take any book depreciation. I will agree with you it has no necessarily close relationship.

Q That is right.

A But it has some relationship.

Q It would not afford - let us put it this way - it would not afford a true measure of the amount of physical depreciation in the plant ?

A I would judge not. I believe you recall me saying irrespective of what figure they had in their books I would choose to

recompute it as a matter of security.

Q Mind you I preface my question on this, not that I take it you raised the point but that somebody else in this hearing may. Is this not also a fair assumption that the book depreciation of Royalite in this $1,100,000.00 odd does not have any true relation to the overall service life of the plant ?

A I would judge not from the evidence.

Q And that this book depreciation set up by Royalite with respect to this plant, it is fair to assume has been set up on the basis of consideration for several matters. First of all income tax would be one ?

A I would judge that would be the first one.

Q And the dividend policy would have something to do with it too ?

A Might have.

Q And the retention of monies for development might very well have ?

A Might have.

Q Those are things that Directors quite properly take into account ?

A Yes.

Q And you have been not only Auditing books for industrial concerns in this Province, but you have been consulted by Directors -- on various situations along these lines ?

A Yes, I feel it only proper to remark almost every Director takes the maximum tax allowance that they can in these times.

Q In these times because the rate of taxation is particularly high ?

A Even when the rates were low they did the same thing to their sorrow.

Q But now they pay more attention to it ?

A Possibly.

Q And as I understand your Exhibit 125 you in effect say this, that if Royalite had only set up a very small depreciation, an amount of say $100,000.00, you do not suggest that for the purpose of Madison rate base only that amount should have been deducted from either present day costs or historical costs. Would you go that far ?

A I do not want to say yes or no to that. It just depends upon how your question is phrased. I agree with you but I do not know which answer indicates agreement.

Q In other words I take it from your Exhibit 125 you in effect say that the book depreciation is not the proper amount that should be taken by the Board in fixing the present day depreciation for rate base purpose. Is that a fair way to put it ?

A For this company, yes sir.

Q Now Royalite did actually put its depreciation at 10% ?

A I think the uniform rate was 10% on all class of assets other than transportation equipment. Mr. Smith can correct me.

Q Now then, Mr. Hamilton, I want to turn to this question of historical costs and on WH 3 of Volume 1, Exhibit 124, you show the total historical costs of the physical plant to be $1,930,971.77 ?

A Yes sir.

Q And that is the same physical plant that is described by Mr. Hill in his Exhibit 59 ?

A Yes sir.

Q And I think you brought up to date the additions made by Mr. Hill in his Exhibit 60 ?

A I did not have to adjust for those sir. They were in the historical costs. That is how Mr. Hill came to make the adjustment, as a matter of fact because they were brought to light in

this comparison.

Q That historical cost figure of $1,930,971.77 shown on WH 3 does not include the prepaid Girbotol royalty of $29,974.38 ?

A That is not in that figure.

Q It does not include the prepaid royalty ?

A I do not think that is the correct figure for it.

Q That was the original figure ?

A Yes, it does not include the Girbotol royalty.

Q It does not include the Girbotol solution of $14,467.00 ?

A No sir.

Q And it does not include transportation charges of $28,750.00 ?

A No sir.

Q Which Hill put in, nor construction charges of $5300.00 ?

A No sir, nor for overhead either.

Q Now those additional items of $78,491.38 are taken in as I understand in your WH 6. Is that right ?

A That is right sir.

(Go to Page 3693)

A It includes the Girbotol solution arrangements and construction equipment charges on the basis suggested by Mr. Hill and also general overhead. These items were allowed in WH 6 in addition to what appears in WH 5. Pardon me, WH 4.

Q Yes, in WH 6 you show a total of $2,157,642.76.

A Yes. That still excludes the prepaid Girbotol royalty.

Q I see.

A I might remark about this prepaid Girbotol royalty, the reason why it has been excluded by ourselves and also by Madison is that it has a definite life which is not geared to the life of the field at all. It has to be amortized over that specific period of time so both Madison and ourselves propose to deal with it on a separate basis.

Q MR. STEER: Where is that dealt with?

A It is dealt with in Madison . . . . . I think the closest reference is to Schedule M-9-2, '44. That indicates the principle and the amount is to be valued downwards slightly.

Q May I ask another question? Over what period is it proposed to be amortized?

A I do not remember offhand. Mr. Smith knows. 17 years is the figure I had in mind. It was originally 25 years was it not?

MR. SMITH: No, 7 years or . . . . .

A It is being amortized at the rate of around $4000 a year, and there is only $21,000 to go, so it would be something like 5 years.

Q MR. CHAMBERS: What I am getting at is this. I am suggesting that the total historical cost, excluding working capital, should in any event be $2,190,315.15. And here is how I arrive at it. I take your figure of $1,930,971.77 as

you show in WH 3 and I add to that $78,491.38.

A What is that again, sir?

Q $78,491.38 which is including the Girbotol which is part of the historical cost I am suggesting.

A What amount for the Girbotol, please?

Q The Girbotol is in at $29,974.38.

A You are asking me to assume that figure is unchanged.

Q Yes.

A I follow you.

Q The reason I am suggesting that, we are talking about historical cost at the moment and that those two figures give us $2,009,463.15.

A One moment please, what was your figure again? $2,009,463.15?

Q Correct.

A Yes, subject to that Girbotol being correct.

Q And that figure does not include anything for overhead during construction. I am suggesting you add to that 9% or $180,852 and you get a grand total of $2,190,315.15 and that that would be the straight historical cost instead of $2,157,642.76 shown on WH 6.

A Well I want to make it clear again that I believe, in principle, that the Girbotol prepaid royalty should be out of that figure for the simple reason it must be amortized over a shorter period than the other assets. That is in accord with the treatment given by ourselves and also by the Madison Company in their submission, that the prepaid Girbotol royalty should be dealt with separately on a basis somewhat intermediate between working capital and rate base. I think that is very sound.

Q In order to instal the Girbotol plant the Company had to make some arrangement with the Girbotol Company as to royalty.

A That is right.

Q And they saw fit to make a cash payment by virtue of which they bought so much paid-up royalty.

A Yes sir.

Q I am suggesting to you, Mr. Hamilton, that that royalty is just as much part of the capital cost of putting that plant in as if you were putting in one of the stacks or solution pumps and that therefore it is part of the historical cost of the plant down there and that it is fair to allow 9% on that item along with the others. What do you say as to that?

A Well you are asking me to assume that the prepaid royalty contract was entered into and was just as essential for the plant as some other item of equipment, physical equipment?

Q Yes.

A My understanding was that the prepayment that was actually made and worked out with the Girbotol people was one alternative selected out of several proposals that were under consideration. On this particular basis, the original investment of 27,000-odd dollars in prepaid royalty will expire in 4 or 5 years, at which time some further arrangement will have to be made and we might assume that another 5-year arrangement will be entered into. If that were capitalized and placed in the rate base, we would find at the end of 25 years we were paying 5 royalties in the rate base.

Q I am suggesting for the purpose of this Board now to ascertain the rate base on a historical cost basis that it is a fair proposition to include what the company paid out for that royalty and that the company should be entitled to the 9% overhead on that. What do you say? You do not

agree with that?

A I agree that the company is entitled to a recouping of the outlay but I just differ with the suggestion you make as to how it does be recouped. Certainly I do not think it should go into the rate base. I still agree it should be a recompense to the company. Whether they get 9% overhead on it or not . . . . .

Q Yes, what do you say as to that?

A As to that particular point?

Q Yes.

A I have no quarrel with that. I admit the negotiation of that contract was a matter of some considerable trouble and expense to this company and the bare dollars that they paid out under the contract would not express the full cost of entering into the arrangement.

Q Yes, that is so. Would you agree that it is a matter that legal advice would have to be taken on as well as engineering advice?

A Quite. I would be more inclined to give them 9% on that than perhaps on some other things. I would rather give it to them on that than the purchase of an automobile.

Q But as I understand it in any case, you agree that the Girbotol royalty should be in the rate base somewhere.

A Not in the rate base itself, to be amortized over the life but to be dealt with separately. That is the soundest way to deal with it.

Q It would go into the rate base but that the question of future depreciation and amortization of it, that is another matter.

A Yes. It goes in the general rate base but not in the main

rate base, put it that way.

Q I see. Now in Exhibit 124, and again as I take it in Exhibit 125 you accept Hill's 9% for general overhead during construction as a reasonable allowance.

A Yes sir.

Q As a matter of fact it arrs on the side of being low if anything.

A I would say it was a good figure.

Q In your experience in dealing with accounts of companies, would you say that the general overhead which is used in the great majority of cases is higher?

A It depends on what you treat as overhead, sir. I had in mind particularly the nature of the construction of the capital accounts of the Royalite Company and I am satisfied that there is very little in the way of indirect expense included in these accounts. Consequently I think the 9% allowance is well within reason. I might qualify that. I would not say "well within reason" but "within reason".

MR. CHAMBERS: If the Board will pardon me a minute I might just shorten this.

THE CHAIRMAN: Take all the time you wish, Mr. Chambers, this is too important to hurry.

Q MR. CHAMBERS: The 9% overhead allowance that you have adopted and applied to your historical cost, that would not include or take care of any amount for the organization or incorporation of the company?

A You mean the Madison company?

Q No, the Royalite Company, in setting up the Madison to own these assets. You see what I am approaching is this, that the Madison Company is taking over assets from Royalite.

A Yes sir.

Q And you in effect say that the rate base to Madison or in effedt a fair price to be paid by Madison to the Royalite is the actual historical cost of this set-up. I am suggesting to you that the 9% does not cover anything for setting up the Royalite Company?

A No sir. I do not think it has any bearing on it.

Q It does include financing costs?

A No sir. Except to the extent that 9% includes an allowance for interest during construction.

Q Nor does it include a reward to the promoters?

A No sir.

Q In that connection, I am going to put to you, or read to you, a statement from Bryant and Herrmann, "Elements of Utility Rate Determination," published in 1940. At page 52, it is headed "Promotion and Financing: - Before any new enterprise can be started and the public can be given the benefit of its services, some person or group of persons must have the courage to plan the enterprise. When the enterprises are new in character, these services require more courage and foresight than do those which have been demonstrated in other localities. The persons who make the original plans and who risk their money and reputations are called promoters. They are rewarded by certain concessions of capital stock or special profits in most enterprises, but, whatever the means of reward, these costs are a real part of the expenses of starting the enterprise on its way."

Now you say that in the historical cost rate base that you recommend to the Board, it does not allow anything for that?

A Not specifically, no sir.

Q Well, not specifically. Does it in any other way?

A To the extent it might be in some part of that 9% but not otherwise. There is no intention to include it as a specific item, sir, no.

Q Then the writer goes on: "This fact was well stated in an early case before the New York Commission, as follows:" and he quotes from Re Rochester C.E. Traction Company:

"'Another subject of great interest and importance is the compensation, if any, to which the promoters of the enterprise should be entitled for their services. Promotion has been so extensively abused, and has been so universally used as a cover for abuses in capitalization, that it has come to be regarded as a term of reproach, and as a device to work schemes of robbery upon the investing public. No reason is apparent why this should necessarily be so. The honest services of a capable promoter are indispensable to the flotation of every comprehensive and far-reaching scheme of development in the railroad world, or elsewhere. A clear vision to see opportunities, ability to demonstrate them to others, and energy to push to completion works untried, but of great moment, are indispensable to material development and should be fairly and even liberally rewarded by the public, which receives the benefits of these works. Such rewards, however, should be put on a clear basis of business principles, should be of sufficient magnitude to encourage rather than to discourage enterprise, and should not be so great as to make an exorbitant demand which is perpetual in nature,

"'upon the community to be served. They are to be treated simply as just payment for services performed for the corporation, which services are valuable, and in many cases indispensable. Such services should be paid for upon the basis of what they are fairly worth, having regard to all circumstances of the case.'"

Now I am suggesting, Mr. Hamilton, that your rate base, as recommended, does not include anything for promotion of the nature described in the extract I have just read.

A That is so, sir.

Q Well now do you not think that the people who perceived this in the first instance and who negotiated so as to get a market and purchased wells or undertook drilling operations and so on, should be in some measure reimbursed in an historical cost rate base?

A There are two observations there, Mr. Chambers, and they are these. In the first place, as I envisage the development of the Royalite Oil Company, it did not blossom out over night as a large, far-flung utility, but grew step by step from a small beginning, each new development being fairly predicated on what had gone before. I do not think there was the same risk involved or the same promotional activity required in establishing the Royalite activity as there was in, we will say, an electric power plant. The other observation I might make is this, that I can see no objection to the Board taking this entrepreneurial reward to some extent in determining the rate of return into account.

Q No, but assuming the rate of return is to be fixed and measured by what rate of return in other enterprises are at the present time - now assuming the Board applies that test and no other, if this matter will not be taken care of in the rate base, it will not be taken care of at all?

A I will say this, you will recall my suggestion earlier this morning, that the question of rate base and the question of rate return cannot be entirely disassociated. You must consider first one and then the other, to see that you have not left anything out.

Q I do not want you to go into the rate of return at the moment but you recall the basis upon which the rate of return is to be fixed as mentioned by Mr. Justice Lamont in the Supreme Court of Canada?

A Yes.

Q And the test that he applied there does not refer to any particular, - does not depend upon the rate base being constructed in any particular way, does it?

A No sir, but a host of other authorities will tell you that you cannot deal with the one without the other and come to any conclusion.

Q But I am suggesting to you, Mr. Hamilton, that those other authorities to which you refer do not have the same weight here as a judgment of the Supreme Court of Canada?

A That may be so, sir.

Q But in any event for the purposes of our discussion, assuming the Board does not take care of the rate of return, would you think it fair that there should be some allowance added to this historical cost rate base?

A Well I say it is a factor. It comes pretty well within the

concept of going value, it means pretty well the same sort of thing which you have here in an established system of business which is something much more than sticks and stones and pieces of pipe. It is a going operation.

Q It is a going concern?

A Quite, sir, I appreciate that.

Q And there is nothing allowed for that in your rate base?

A No going value allowed in mine, no sir.

Q And there is nothing allowed for the value or services of a nature which is referred to on page 52, which I have read to you?

A What are they again? "Promotion"?

Q "Promotion"?

A I would include "Promotion" along with going value. Going value presupposes something which would have been promoted, but when you say there has been no consideration given, I think I should refer to this too, that in adopting the historical basis you take the best elements of your plant and the worst elements of your plant all in the same basis and you offset what might be going value.

Q But on the other hand you only give to the company the effect of the dollars which it has spent in 1921, is that not right?

A What is that?

Q On the historical cost basis you only give effect to the company, of the value of the dollar which it spent in 1921, and that same dollar today is worth more, that is one element?

A We are going to price levels now.

Q Yes?

A We are going back actually to what they spent depending on when they spent it.

Q Yes. Now talking about price levels, Mr. Hamilton, I think you already said in your report, Exhibit 124, that the Dominion Bureau of Statistics, which is responsible for the issuing of the Canada Year Book, regards the year 1926 as the normal pre-war year

A Oh, no sir, it is just the base year.

Q You do not think that they regard it as the normal pre-war year?

A Not necessarily. They did not know when they adopted that year whether that was average or not. They had to take some point as a starting point.

Q Anyway they used 1926, that year, as the index?

A As the base year, it is one hundred, yes, and every year is related to it.

Q And I suggest to you the comparable figure for the year 1913, immediately prior to the First Great War, was 67.7 and I think in fairness to you I should refer you to it?

A I wish you would, Sir.

Q To the Canada Year Book for the year 1943-44, at page 786.

A Is that like my Table here?

Q No, I do not think so, I will leave you this one.

A Your question again now, Mr.Chambers?

Q In comparison with 1926, the index year, the comparable index figure for 1913 was 67.7, is that right?

A You are speaking now of the index figure for building and construction materials.

Q Yes?

A Well I assume the base year for that was 1926, although it does not say so in here.

Q There it is?

A Oh yes, right.

Q And I suggest that that 67.7 figure has never been reached again since the last war?

A No sir.

Q Now on W-H-9, Volume 1, Exhibit 124, at the bottom of the page, you refer to:

"Price index producer equipment - from Canada Year Book, 1938, page 816, and 1942, pages 730-31."

Now what do you understand by this term "producer equipment", Mr. Hamilton?

A As you will recall yesterday I mentioned that this particular price index was one of several which might be selected. I did not go to the extent of inquiring from the Bureau of Statistics whether or not the particular type of plant which we are now appraising or considering here, would properly fall within that "producer equipment" index, but I was informed by the Board's engineer that in his opinion, after reviewing the various schedules of statistics there, that that was the one which was most appropriate in the present instance, but it might not be.

Q Well I am suggesting that in this matter you should consider the price index for "producer goods", which represents the average index for producer equipment and producer material, and I get that from page 813 of the Canada Year Book, 1940, I think it is.

(Year Book handed to the witness).

All commodities, and it takes in producer material and producer goods, you see?

A Which index are you now suggesting would be more appropriate?

Q The producer material, or excuse me, the producer goods, rather.

A The producer goods.

Q Which, as I understand it, from that Year Book, includes both equipment and material, is that right?

A That would now be the column against which you have this tick mark?

Q Yes?

A It might be that that is a more appropriate index.

Q And should we not also consider the wage scale?

A Oh, I assume that the wage scale is bound to be reflected in the cost of producer equipment.

Q That is not necessarily reflected in the material you buy though, and should you not therefore put it in, would that not be fair?

A The installation cost involves more than labour, it involves labour and supplies in the form of intangibles, as we have in the gas gathering lines.

Q Now, Mr. Hamilton, will you let me check with you through the index of these consumer goods, or producer goods rather, they take 1926 as the index year?

A The date year.

Q The date year, and this is Volume 1940, now let me get you 1943, to see if there is any difference, I am referring now to page 731 of the Canada Year Book, 1943-44, now they take 1935 to 1939 as the index year, do they not?

A Yes.

Q And in 1926 the weighted average was 99.4, that is right?

A Yes, which suggests that the 1935 to 1939 average is slightly in excess of the 1926 year which was the base year in the other index.

Q Yes, and I am also suggesting to you that this Table shows that

in the years prior to the war, 1937, 1938 and 1939, the general average, weighted average for wages was over the base year?

A Yes, but not to any tremendous degree. In 1937 it was 101.8 as compared with 99.4 in 1936 and so on up. In 1939, which we might refer to next, it is 105.3, compared with 99.4.

Q And in 1940 it was 108.4?

A Yes.

Q And 1941 it is 119.2?

A Yes.

Q And in 1942 it is 127.3?

A Yes.

Q Then I also refer you, Mr. Hamilton, to page 785 of the Canada Year Book, 1940, the index numbers on rates of wages for various classes of labour in Canada, and the last column is the general average weighted and they take 1913 as the base year and call that 100?

A Yes.

Q Now you will notice there from 1913 down to 1939 there is certainly a substantial increase?

A Yes, in every group too.

Q And it never, after 1913, dropped below 100?

A I do not know.

Q You might check it. Now the general weighted average, it never dropped below 100 again?

A No.

Q And in 1917 it was 125.6, the weighted average?

A Yes.

Q And in 1922 it was 180.2?

A Yes.

Q And in 1927 it was 190.4?

A Yes.

Q And in 1932 it was 177.7?

A Correct.

Q In 1937 it was 191.7?

A Yes.

Q And in 1938 it was 197.4?

A Yes.

Q In 1939 it was 198.3?

A Yes.

MR. BLANCHARD: Are those real wages or dollars?

MR. CHAMBERS: The price index is part of it.

WITNESS: It is dollar-wages, I think, and not the real wages.

MR. CHAMBERS: Now then going on.....

THE CHAIRMAN: Perhaps you had better not start another branch.

MR. CHAMBERS: Well, I was going to pursue an entirely different branch.

THE CHAIRMAN: Then if it is a new branch, I think we had better adjourn now.

(The Hearing was accordingly adjourned to be resumed at 9.30 A.M., October 11th, 1945.)